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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, August 10, 2000

JOINT PETITION OF

KENTUCKY UTILITIES COMPANY,  
LOUISVILLE GAS AND ELECTRIC COMPANY

CASE NO. PUA000050

and

LG&E ENERGY SERVICES, INC.

For approval of a services agreement

**ORDER GRANTING APPROVAL**

On June 12, 2000, Kentucky Utilities Company (“KU”), Louisville Gas and Electric Company (“LG&E”), and a newly created services company, LG&E Energy Services, Inc. (“LG&E Energy Services”), (collectively, the “Petitioners”), filed a joint petition pursuant to Chapter 4 of Title 56 of the Code of Virginia (“Code”) for approval of a Service Agreement between KU, LG&E, and LG&E Energy Services, following consummation of the proposed merger of LG&E Energy Corp. (“LG&E Energy”) and PowerGen plc (“PowerGen”).

KU is a public service corporation organized pursuant to the laws of the Commonwealth of Kentucky and the Commonwealth of Virginia. In Kentucky, KU provides retail electric service to approximately 487,000 customers in 77 counties and wholesale service to several municipalities. In Virginia, KU conducts business under the name “Old Dominion Power” and

provides retail electric service to approximately 29,000 customers in five southwestern counties. KU does not have any wholesale customers in Virginia<sup>1</sup>.

LG&E is a corporation organized under the laws of the Commonwealth of Kentucky. LG&E is a combination gas and electric utility providing service in Kentucky. LG&E is also a wholly owned subsidiary of LG&E Energy.

LG&E Energy Services is a corporation organized under the laws of the Commonwealth of Kentucky and also a wholly owned subsidiary of LG&E Energy.

LG&E Energy is a corporation organized under the laws of the Commonwealth of Kentucky. LG&E Energy is an exempt holding company under the Public Utility Holding Company Act of 1935 (“the 1935 Act”) engaged in co-generation, independent power projects, exempt wholesale generation, and the ownership and operation of two retail electric and gas distribution utilities known as LG&E and KU.

PowerGen is a public limited holding company formed under the laws of England and Wales and is engaged in regulated and unregulated power activities around the world. PowerGen, through its subsidiaries, is a leading integrated electric and gas company in the United Kingdom with significant investments in utility operations outside the United Kingdom and United States.

On February 25, 2000, the Boards of Directors of PowerGen and LG&E Energy approved the Merger Agreement and executed the agreement on February 27, 2000. Under the terms of the Merger Agreement, LG&E Energy will merge with PowerGen Acquisition, a corporation to be formed and indirectly owned by PowerGen for purpose of facilitating the

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<sup>1</sup> By Order dated January 20, 1998, in Case No. PUA970041, the Commission approved the merger of KU’s then parent company, KU Energy Corporation, with and into LG&E Energy with LG&E Energy being the surviving company.

merger. LG&E Energy will survive the merger; PowerGen Acquisition will cease to exist, resulting in LG&E Energy becoming a wholly owned subsidiary of PowerGen.

Following the merger, KU, LG&E, and LG&E Energy Services will be wholly owned, direct operating subsidiaries of LG&E Energy and wholly owned, indirect subsidiaries of PowerGen. PowerGen will own 100 percent of the issued and outstanding stock of LG&E Energy, and LG&E Energy will continue to own 100 percent of the common stock of KU and LG&E.

The Petitioners state that KU will continue to function as a public utility subject to the regulatory jurisdiction of the Virginia Commission, the Kentucky Public Service Commission, and, to the extent required by applicable law, the Tennessee Regulatory Authority. In addition, the Federal Energy Regulatory Commission (“FERC”) will continue to regulate KU’s transmission services and wholesale rates.

The shareholders of PowerGen and LG&E approved the Merger Agreement on June 5 and June 7, 2000. The merger was also approved by the Public Service Commission of Kentucky on May 15, 2000, and by the FERC on June 28, 2000. By Order dated July 21, 2000, in Case No. PUA000020, the Virginia State Corporation Commission also approved the merger. The Petitioners are awaiting approval from the Securities and Exchange Commission (“SEC”), the Department of Justice’s Antitrust Division, the Federal Trade Commission, and the Tennessee Regulatory Authority<sup>2</sup>.

Pursuant to the proposed merger, PowerGen and the intermediate companies are expected to register with the SEC as holding companies under the 1935 Act. (15 U.S.C. §79m). Among other things, Section 13 of the 1935 Act prohibits registered holding companies from providing goods and services at a fee to operating utility subsidiaries, and it greatly restricts operating

companies from providing goods and services directly to each other. However, the 1935 Act does permit registered holding companies to establish a service company subsidiary to provide centralized services to it and its subsidiaries.

Because of the provisions of the 1935 Act, LG&E Energy Services, a new service company subsidiary of LG&E Energy, was formed to provide services to KU and the other affiliates and subsidiaries of LG&E Energy and, to a lesser extent, affiliates and subsidiaries of PowerGen. It is anticipated that LG&E Energy Services will be staffed primarily by the transfer of personnel from LG&E Energy, LG&E, KU, and their subsidiaries.

The SEC will have regulatory authority regarding the governance of LG&E Energy Services and the allocation of costs. Such regulations are designed to ensure that the activities performed by the service company are “necessary or appropriate in the public interest or for the protection of investors or consumers and to insure that such [services] are performed economically and efficiently for the benefit of such associate companies at cost, fairly and equitably allocated among such companies.” 15 U.S.C. §79m(b). Accounting for service company costs will comply with the SEC’s Uniform System of Accounts for Mutual Service Companies and Subsidiary Companies under the 1935 Act. Costs will either be directly assigned to the benefiting subsidiary or allocated using allocations methods approved by the SEC. In addition, costs will be allocated between regulated and unregulated subsidiaries and between utility operating companies, in an appropriate manner, with no adverse consequences to KU utility customers. Furthermore, the Petitioners state that the Commission Staff will have access to the books and records of LG&E Energy, LG&E, LG&E Energy Services, and PowerGen and the intermediate companies consistent with the exercise of the Commission’s ratemaking jurisdiction and authority.

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<sup>2</sup> By letter dated August 9, 2000, the Petitioners notified Staff that the only regulatory approval required for the

The Petitioners state that, after approval and consummation of the proposed merger, KU will continue to be a public utility under and subject to the Commission's jurisdiction. The Commission will have the same ratemaking and regulatory authority to regulate the rates and services of KU as it did before the merger. Furthermore, KU committed in ¶17 of its Application in *Joint Petition of PowerGen plc, LG&E Energy Corp. and Kentucky Utilities Company d/b/a Old Dominion Power Company for Approval of a Merger*, Case No. PUA000020 that it would not assert that the SEC's jurisdiction legally preempts the Virginia Commission from disallowing recovery in retail rates of the cost of goods and services that it obtains from LG&E and/or LG&E Services, and it reaffirms such commitment in this proceeding. KU otherwise retains the right to assert that the charges are reasonable and appropriate.

The Petitioners are aware that questions concerning the FERC's policy in this area are likely to arise with respect to affiliate transactions involving KU. In connection with the merger application filed with FERC, the parties represent that, with respect to any transactions between KU and PowerGen and any of its subsidiary or affiliated companies, KU will abide by FERC policy regarding intra-affiliate transactions. The FERC intra-corporate transactions policy, with respect to non-power goods and services, generally requires affiliates or associates of a public utility not to sell non-power goods and services to a public utility at a price above cost, and sales of non-power goods and services by a public utility to its affiliates or associates are required to be at the public utility's cost for such goods and services or market value, whichever is higher.

Unless exempt, the Petitioners state that all services provided by PowerGen System companies to other companies within the system will be in accordance with the requirements of Section 13 of the 1935 Act and the rules promulgated by the SEC thereunder. Section 13(b) of the 1935 Act generally requires that affiliate transactions involving system utilities be "at cost,

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merger is that of the SEC.

fairly or equitably allocated among such companies.” Nonetheless, KU believes that, as a practical matter, there should not be any irreconcilable inconsistency between the application of the SEC’s “at cost” standard and the Virginia Commission’s policies with respect to intra-system transactions as applied to PowerGen.

The proposed Service Agreement between KU, LG&E, and LG&E Energy Services will allow LG&E Energy Services to provide certain administrative, management, or other services to KU, at its request, and to determine cost incurred by the parties in receiving or providing such services.

The proposed Service Agreement will also allow: (1) for the provision and/or receipt of such services, construction, or goods to or from KU and/or LG&E as are reasonably required to meet a breakdown or other emergency when the parties believe in good faith that, under the conditions then existing, such transactions will be to their advantage and their customers’ advantage; and (2) for KU and/or LG&E to provide or receive from each other any goods, at no more than cost less depreciation, that were purchased by each for their own use. The two types of affiliate transactions are permissible exceptions to the general SEC prohibition that one company cannot provide services to an associate company unless it is through an approved services company (C.F.R. § 250.87).

The Petitioners state that, after consummation of the merger, LG&E Energy Services proposes to provide a variety of administrative, management, and support services to KU pursuant to a service contract. Although the full scope of services is not known at this time, the services may include: information system services; customer services; marketing and sales; employee services; corporate compliance; purchasing; financial services; risk management; public affairs and regulatory; legal services; investor services; telecommunications; gas supply and capacity management; transmission, substation construction, maintenance and operations;

meter reading, repair and maintenance; design engineering; substation engineering and support; resource acquisition and analysis; purchased power and electric trading; strategic planning; executive; environmental affairs; energy supply; transportation; and media relations. LG&E Energy Services may also provide special services as may be requested by KU. In supplying such special services, LG&E Energy Services may arrange, where it deems appropriate, for the services of such experts, consultants, advisors, and other persons with necessary qualifications as are required for or pertinent to the provision of services.

The Petitioners also state that LG&E Energy Services will maintain and fully document distinct and separate accounting and financial records for services provided to KU. The proposed Service Agreement describes the accounting, cost accumulation and allocation methodology, and billing procedures. All services will be priced at cost and directly assigned, distributed, or allocated by activity, project, program, work order, or other appropriate basis in accordance with SEC standards. 17CFR §§ 256.01-7 and 256.01-2. Allocated costs will include: (1) total payroll and associated costs; (2) materials and consumable costs; (3) building and facilities costs; (4) IS infrastructure costs; and (5) other departmental costs.

KU and LG&E Energy services will prepare a service request each year listing services to be provided to KU and any special arrangements related to the provision of such services. The service request may be modified and/or supplemented by KU during the year. Also, any party may terminate the Service Agreement by providing sixty (60) days written notice of such termination to the remaining parties. In addition, the proposed Service Agreement is subject to termination or modification at any time to the extent its performance may conflict with the provisions of the 1935 Act or with any rule, regulation, or order of the SEC.

In addition to the monthly charges from LG&E Energy Services, KU also will be charged with a portion of the group member costs associated with being a member of the PowerGen

System. Allocation of group member costs follow the methodology adopted by the U.K. regulator, the Office of Gas and Electricity Markets (“OFGEM”). The OFGEM approach uses four measures (revenues, operating profit, employee numbers, and net assets) to allocate group member costs.

On August 7, 2000, Staff filed a Report detailing its findings and recommendations. In its Report, Staff recommends approval of the Joint Petition, subject to the provisions of § 56-80 and certain conditions detailed therein.

By letter dated August 9, 2000, the Petitioners agreed with Staff’s conclusions and recommendations with the exception of the conditions referenced as nos. 9, 10, and 11<sup>3</sup>. By subsequent letters dated that same day, the Petitioners provided additional information and stated that the complaint procedures currently in place for KU customers are not expected to change and that customers currently have notice of the call number for customer complaints. The Petitioners also stated that each billing statement will contain the then current call number for inquiries and complaints.

NOW THE COMMISSION, upon consideration of the application and representations of Petitioners and having been advised by its Staff, is of the opinion and finds that the above described transactions are in the public interest and should be approved, subject to the conditions detailed herein. Further, we find that the pricing of non-tariffed services provided by KU to LG&E should be at cost instead of the higher of cost or market as recommended in the Staff Report. One cost standard should be in effect for affiliate transactions between regulated utilities. If both regulated entities use the higher of cost or market standard neither could provide services to one another. Accordingly,

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<sup>3</sup> Condition no. 9 concerns customer dispute resolution procedures, condition no. 10 relates to customer notification of such procedures, and condition no. 11 concerns KU’s continuing responsibility for quality customer service even though actual performance of customer services will be transferred to LG&E Energy Services.



IT IS ORDERED THAT:

- 1) Pursuant to Code § 56-77, the Service Agreement is approved as filed subject to representations made by the Petitioners and is effective upon the closing of the PowerGen and LG&E Energy merger;
- 2) No changes in the terms, conditions, or types of services described in the Service Agreement approved herein shall be made without prior Commission approval; such changes shall include, but are not limited to, services provided to any other affiliate;
- 3) The approval granted herein for the Service Agreement between KU, LG&E, and LG&E Energy Services shall not preclude the Commission from exercising its authority under the provisions of Code §§ 56-78 through 56-80 hereafter. Further, the approvals granted herein may be modified or revoked in connection with the Commission's authority and obligations under the Restructuring Act, including Code § 56-590;
- 4) All services provided by LG&E Energy Services to KU shall be at the lower of cost or market. Appropriate documentation of such transactions shall be made available for Staff review upon request;
- 5) All non-tariffed services provided by KU to LG&E shall be at cost. Any tariffed services provided by KU to LG&E shall be billed at the tariff rate. Appropriate documentation of such transactions shall be made available for Staff review upon request;
- 6) KU shall have the burden of proving that all goods and services procured from LG&E Energy Services or any other affiliate have been procured on the most favorable terms and conditions reasonably available in the market, which shall

include a showing that such goods or services could not have been procured at a lower cost from non-affiliate sources or that KU could not have provided the services or goods to itself at a lower cost;

- 7) The Commission reserves the right to examine the books and records of any affiliate in connection with the authority granted herein whether or not such affiliate is regulated by this Commission. KU shall include in all general rate proceedings and Annual Informational Filings evidence that the pricing policies stated herein have been followed;
- 8) Petitioners shall not to assert, in any forum, that the SEC jurisdiction legally preempts the Commission from disallowing recovery in retail rates for the costs of goods and services that KU obtains from or transfers to an associate, affiliate, or subsidiary in the same holding company system. However, KU should retain the right to assert that the charges are reasonable and appropriate. Further, the Petitioners commit to oppose any challenge or defense raised by any party that seeks to abrogate the Commission's authority on the grounds of federal preemption under the 1935 Act;
- 9) The Petitioners shall bear the full risk of any preemptive effects of the 1935 Act and shall take all such action as the Commission finds is necessary and appropriate as a result of possible 1935 Act preemptive effect to hold Virginia ratepayers harmless from rate increases or foregone opportunities for rate decreases. Such actions may include, but not limited to, filing with and seeking to obtain approval from the SEC for such commitments as deemed necessary to prevent such preemptive effects;

- 10) If the 1935 Act is repealed, amended, or replaced by future legislation, the Petitioners shall meet with the Commission Staff after passage of such legislation and negotiate in good faith whether and how any transactions approved in the Joint Petition have been affected by such legislation and whether they should be revised or terminated. In the event the Petitioners and Staff are unable to reach agreement, the unresolved issues shall be submitted to the Commission for resolution;
- 11) Petitioners shall provide the Commission with notice thirty (30) days prior to any SEC filing that proposes new allocation factors. The notice should include a description of the proposed factors and the reasons supporting such factors. The Petitioners should make a good faith attempt to resolve differences, if any, with the Commission before filing with the SEC;
- 12) KU shall submit to the Commission's Division of Public Utility Accounting a copy of all documents or reports filed with the SEC under the 1935 Act by LG&E Energy and LG&E Energy Services as well as copies of all orders issued by the SEC directly affecting KU's accounting practices;
- 13) The Commission's Division of Energy Regulation shall be notified in writing of any proposed change in the customer dispute resolution procedures at least thirty (30) days prior to the effective date of the proposed change. Customers shall be notified of any change prior to the effective date of the change.
- 14) KU shall ultimately be held responsible for reliable/quality customer service even though the actual performance of customer services and meter functions will be transferred to LG&E Energy Services;

- 15) KU shall include all transactions with LG&E Energy Services and LG&E in The Annual Report of Affiliated Transactions to be submitted to the Director of Public Utility Accounting of the Commission by no later than May 1 of each year. Such report shall include all agreements with affiliates regardless of the amount involved and shall supersede all other affiliate reporting requirements previously ordered.
- 16) The Petitioners shall not create joint lines of credit or implement guarantees, collateralization, or support agreements between KU and LG&E Energy or its subsidiaries without prior Commission approval. Further, prior Commission approval shall be required for any proposed money pool arrangement.
- 17) This matter shall be continued generally subject to the continuing review, audit, and appropriate directive of the Commission.